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In the Supreme Court
OF THE
United States

OCTOBER TERM, 1944

No. 1049 1052

SANTA INEZ COMPANY (a corporation),
Petitioner,

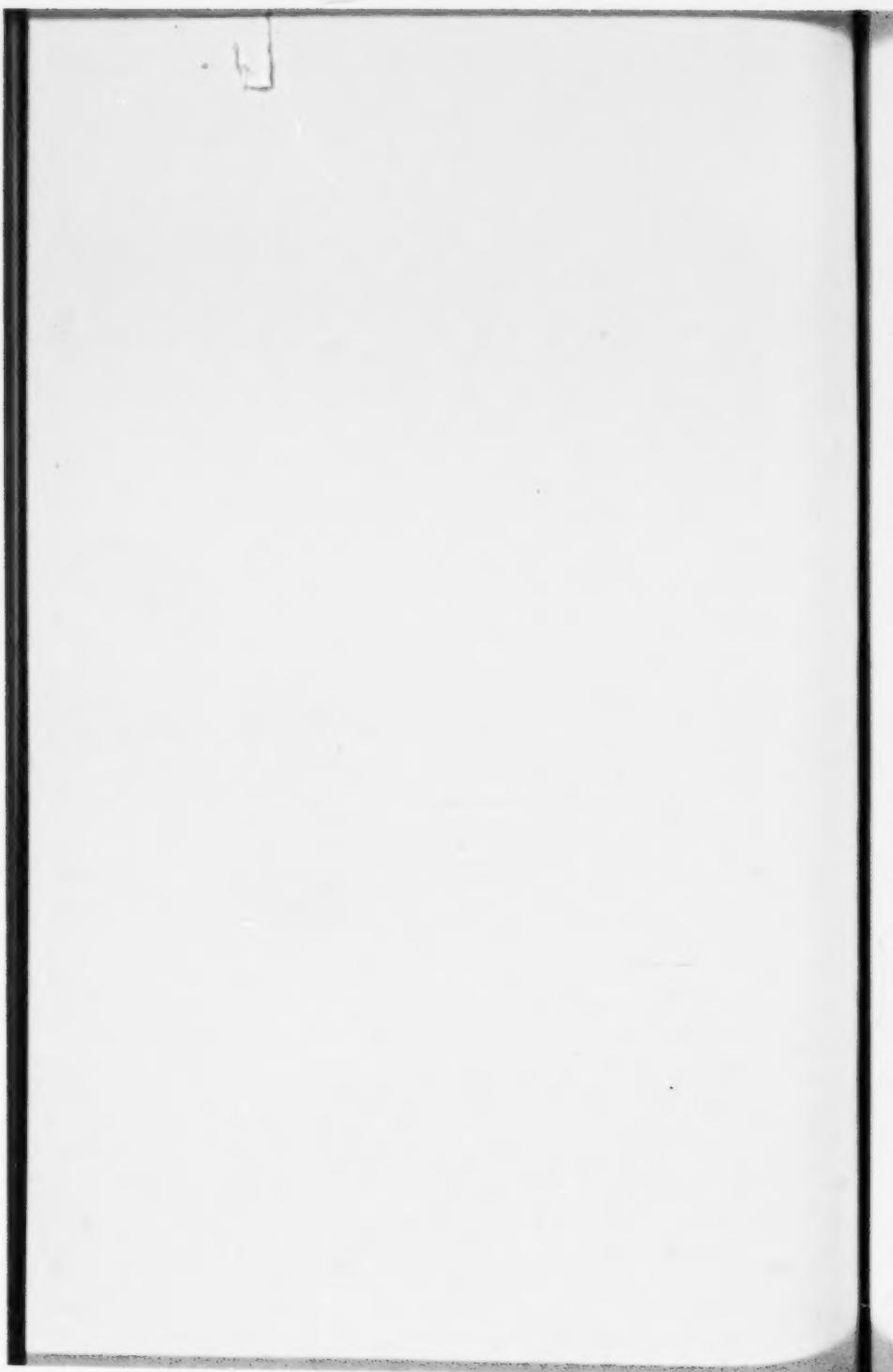
vs.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR WRIT OF CERTIORARI
to the United States Circuit Court of Appeals
for the Ninth Circuit.

GEORGE NAUS,
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UNITED STATES OF AMERICA,
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PETITION FOR WRIT OF CERTIORARI
to the United States Circuit Court of Appeals
for the Ninth Circuit.

*To the Honorable Harlan Fiske Stone, Chief Justice of
the United States, and to the Honorable Associate
Justices of the Supreme Court of the United
States:*

Petitioner, Santa Inez Company, a corporation, prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals, for the Ninth Circuit, entered in the above entitled cause on November 29, 1944.

OPINION BELOW.

The opinion of the Circuit Court of Appeals is reported in 145 Fed. (2d) 667. (R. 225.)

JURISDICTION.

The judgment of the Circuit Court of Appeals was entered on November 29, 1944. Petition for rehearing therein was denied on January 2, 1945.

The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code as amended by the Act of February 13, 1925.

STATUTE INVOLVED.

The statute involved is the Revenue Act of 1934. The pertinent section is Section 112(b) (5) reading as follows:

"Transfer to Corporation Controlled by Transferor.—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange."

QUESTION PRESENTED.

This case presents the question which was left open by this Court for future determination, in *Helvering v. Cement Investors Inc.*, 316 U. S. 527. The question may be stated as follows:

Under the Revenue Act of 1934 does taxable gain or loss result to holders of defaulted bonds of an insolvent corporation upon the sale of the mortgaged property at public auction and its acquisition by the bondholders, where, pursuant to a pre-existing plan, the sale is merely a requisite step whereby the property is being transferred to a new corporation in exchange for its stock?

STATEMENT OF THE CASE.

In 1928, Whitney Estate Company (hereinafter referred to as Whitney) created an original issue of \$1,200,000.00 principal amount of first mortgage bonds and contemporaneously, as security for the payment of the bonds, executed a mortgage in favor of American Trust Company as trustee, under which certain real estate in San Francisco consisting of land and an office building, were mortgaged as security for the payment of the bonds. (R. 26.) On April 15, 1933, Whitney defaulted in the payment of interest on its bonds, and in the payment of the principal amount of such of the bonds as matured on that date. The defaults were never cured. (R. 26.) On the date of the default and at all pertinent times thereafter, the value of all of the property of Whitney was substantially

less than the principal amount of all of its outstanding bonds. (R. 29.) Subsequent to the default a Bondholders' Protective Committee was formed to safeguard the interests of the bondholders. The Committee accepted deposits of bonds and issued certificates of deposit to the depositing bondholders. (R. 26.) In January, 1934, the Committee formulated a plan which contemplated the following steps:

- (1) The sale of the mortgaged property by the trustee at public auction.
- (2) The purchase of the mortgaged property by the Committee for the benefit of the depositing bondholders.
- (3) The transfer of the property by the Committee to a new corporation in exchange for all of the stock of the new corporation.
- (4) The transfer of the stock of the new corporation by the Committee to the depositing bondholders in exchange for their certificates of deposit. (R. 27.)

Pursuant to the plan, the mortgaged property was sold by the trustee at public auction on February 28, 1934, and purchased by the Committee for a sum less than the face amount of the outstanding bonds. The purchase price was paid by applying the distributive share of the net proceeds of the sale inuring to the bonds held by the Committee and by paying to the trustee in cash the distributive share of the net proceeds of sale inuring to the nondepositing bondholders. Approximately 95% of the issued and out-

standing bonds were on deposit with the Committee. (R. 27, 28.)

Due to the pendency of certain litigation to which Whitney, the trustee and the Committee were parties, the Committee was unable to obtain possession and clear title to the property until May, 1934. After obtaining possession and clear title to the property, the Committee proceeded with its plan to organize a new corporation and to transfer the purchased property thereto. The new corporation was incorporated in September, 1934. In November, 1934, the Committee transferred the purchased property to the new corporation and in exchange therefor the new corporation delivered to the Committee for the benefit of the depositing bondholders all of its capital stock. This stock constituted the sole consideration for the transfer of the property to the new corporation. (R. 28.) Upon receipt of the stock, the Committee distributed it pro rata among the depositing bondholders. (R. 162.)

At all pertinent times petitioner owned certificates of deposit representing \$136,000.00 principal amount of Whitney bonds. Pursuant to the plan formulated by the Committee, petitioner received 1360 shares of the new corporation's stock in exchange for its certificates of deposit. (R. 28, 29.)

In its amended income and excess profits tax return for the year 1934, petitioner reported as capital gain resulting from the disposition of its certificates of deposit the amount by which petitioner's pro rata

share of the fair market value of the mortgaged property exceeded the cost of its Whitney bonds. Petitioner subsequently filed a claim for refund of the tax paid as a result of the aforementioned treatment of the transaction. The claim was not acted upon within six months after filing and suit was brought in the United States District Court for the Northern District of California against the United States. (R. 33.) The United States was named as defendant because the Collector to whom the taxes were paid was out of office. (R. 25.)

The District Court found that petitioner realized no gain as a result of the purchase in 1934 by the Committee for the benefit of the depositing bondholders of the property subject to the Whitney mortgage. The District Court further found that the exchange by the petitioner of its certificates of deposit solely for stock of the new corporation constituted a tax-free exchange under Section 112(b) (5) of the Revenue Act of 1934. (R. 29, 30.) The Circuit Court of Appeals reversed the decision of the District Court and held that taxable gain resulted to petitioner on February 28, 1934, when the Whitney property was sold at public auction by the trustee and purchased by the Committee for the benefit of the depositing bondholders.

SPECIFICATION OF ERRORS TO BE URGED.

The Circuit Court of Appeals erred in holding that taxable gain results to the holders of defaulted bonds

of an insolvent corporation on the sale of the mortgaged property at public auction, where, pursuant to a pre-existing plan, the sale is merely a requisite step whereby the property is being transferred to a new corporation in exchange for its stock.

REASON WHY WRIT SHOULD BE GRANTED.

THE CIRCUIT COURT OF APPEALS DECIDED AN IMPORTANT QUESTION OF FEDERAL LAW WHICH HAS NOT BEEN, BUT SHOULD BE SETTLED BY THIS COURT.

This Court frequently has had occasion to consider the tax status of so-called "reorganizations" involving the transfer of the assets of an insolvent corporation to a newly organized corporation.

Under the broad definition of the term "reorganization" contained in the 1928 and 1932 Revenue Acts, this Court has held that a nontaxable statutory "reorganization" results where the assets of the insolvent corporation are turned over to a new corporation in exchange for the latter's stock, with the stock in turn being issued to the bondholders or creditors of the insolvent corporation. (*Helvering v. Alabama Asphaltic Limestone Company*, 315 U. S. 179, where the transfer was consummated through the medium of a bankruptcy sale; *Palm Springs Holding Corporation v. Commissioner*, 315 U. S. 185, where the transfer was effected through the medium of a foreclosure sale.)

While the issue has been settled as to the status of these transactions in cases arising under the 1928 and

1932 Revenue Acts, it has never been settled in cases arising under the 1934 and subsequent Revenue Acts. In *Helvering v. Southwest Consolidated Corporation*, 315 U. S. 194, this Court held that, because of the narrower definition of the term "reorganization" contained in the 1934 and later Revenue Acts, a transaction similar to those considered in the *Palm Springs* and *Alabama* cases did not result in a nontaxable "reorganization." The question as to the status under the 1934 and subsequent Revenue Acts of transactions of the character under consideration in the *Palm Springs*, *Alabama* and *Southwest Consolidated* cases was subsequently considered from a different approach but was by no means settled in *Helvering v. Cement Investors, Inc.*, 316 U. S. 527. In that case which arose under the Revenue Act of 1936, this Court held that no taxable gain resulted to holders of bonds of an insolvent corporation where, pursuant to a plan of reorganization adopted in proceedings initiated under Section 77B of the Bankruptcy Act, the assets of the insolvent corporation were transferred to a new corporation and stock and income bonds of the new corporation were issued to the bondholders in exchange for their bonds. The Court recognized that upon the authority of *Helvering v. Southwest Consolidated Corporation*, supra, the transaction could not qualify as a "reorganization." The Court held, however, that prior to the date of the exchange, the bondholders had acquired the entire equitable interest in the mortgaged property and that the transfer of this equitable interest for stock and other securities

of the new corporation was tax-free under Section 112(b) (5) of the Revenue Act of 1936. That section, which is identical in language with Section 112(b) (5) of the Revenue Act of 1934 (the Act involved in the instant case) provides for the nonrecognition of gain or loss where "property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation." The Commissioner contended that even though Section 112(b) (5) applied to prevent the recognition of gain on the exchange of the mortgaged property for the stock and other securities of the new corporation, nevertheless taxable gain resulted when the bondholders acquired their equitable interest in the mortgaged property in substitution for their old bonds. With respect to this contention, the Court stated at page 535:

"Thus the contention seems to be that since a gain arose from a transaction which was separate and distinct from and anterior to the exchange of property for the new securities, it must be recognized under the general rule of § 112(a). We express no view on that contention. The deficiencies were not assessed on that transaction but only upon the exchange of stock and securities in the new corporation for bonds of the old. We will not consider here for the first time the question whether a tax liability may have been incurred under § 112(a) by reason of the earlier transaction, a question not fairly within the issues as framed by the Commissioner and hence not decided below."

The instant case squarely presents the issue which was not properly before the Court in the *Cement Investors* case. The Commissioner contends and the Circuit Court held that taxable gain resulted to petitioner on February 28, 1934, when the Whitney property was sold at public auction by the trustee and purchased by the Bondholders' Committee for the benefit of the depositing bondholders. Petitioner contends that no taxable gain resulted from such sale because bondholders acquire the status of equitable owners of the mortgaged property on the date of the default if the debtor is in fact insolvent, and the bondholders' status as equitable owners continues as long as the debtor remains insolvent and the default is not cured. Petitioner's position appears to be sustained by *Helvering v. New Haven & S. L. R. Co. Inc.* (C.C.A. 2), 121 Fed. (2d) 985, where the Court stated that "bondholders acquire a proprietary interest in the mortgaged property as soon as the debtor becomes irrecoverably insolvent and the debts are due" and that the foreclosure sale "did nothing but recognize officially what had before been true in fact." The latter quotation was adopted by this Court in its opinion in *Helvering v. Alabama Asphaltic Limestone Company*, supra.

Because of the narrowness of the issue presented in *Helvering v. Cement Investors Inc.*, supra, the law on the subject matter of so-called "foreclosure re-organizations" will necessarily remain unsettled unless certiorari is granted herein and the vital question which is squarely presented in this case is decided.

It is true that Congress in the Revenue Act of 1943 added Sections 112(b) (10) and 112(e) to the Internal Revenue Code. Those sections provide for the non-recognition of gain or loss under certain specified conditions where pursuant to a plan of reorganization *approved by a Court of competent jurisdiction* corporate assets are transferred to a new corporation solely in exchange for the new corporation's stock or securities. The sections, however, apply only where the plan has been approved by the Court in a receivership, foreclosure or similar proceeding or in a proceeding under Section 77B or Chapter X of the National Bankruptcy Act. The amendment to the Internal Revenue Code effected by the Revenue Act of 1943 makes no provision for the common situation where the transfer is effected without the intervention of judicial proceedings and where the sale of the mortgaged property is made at public auction by the mortgage trustee under power of sale contained in the mortgage.

The question presented herein is of extreme importance and should be finally determined by this Court.

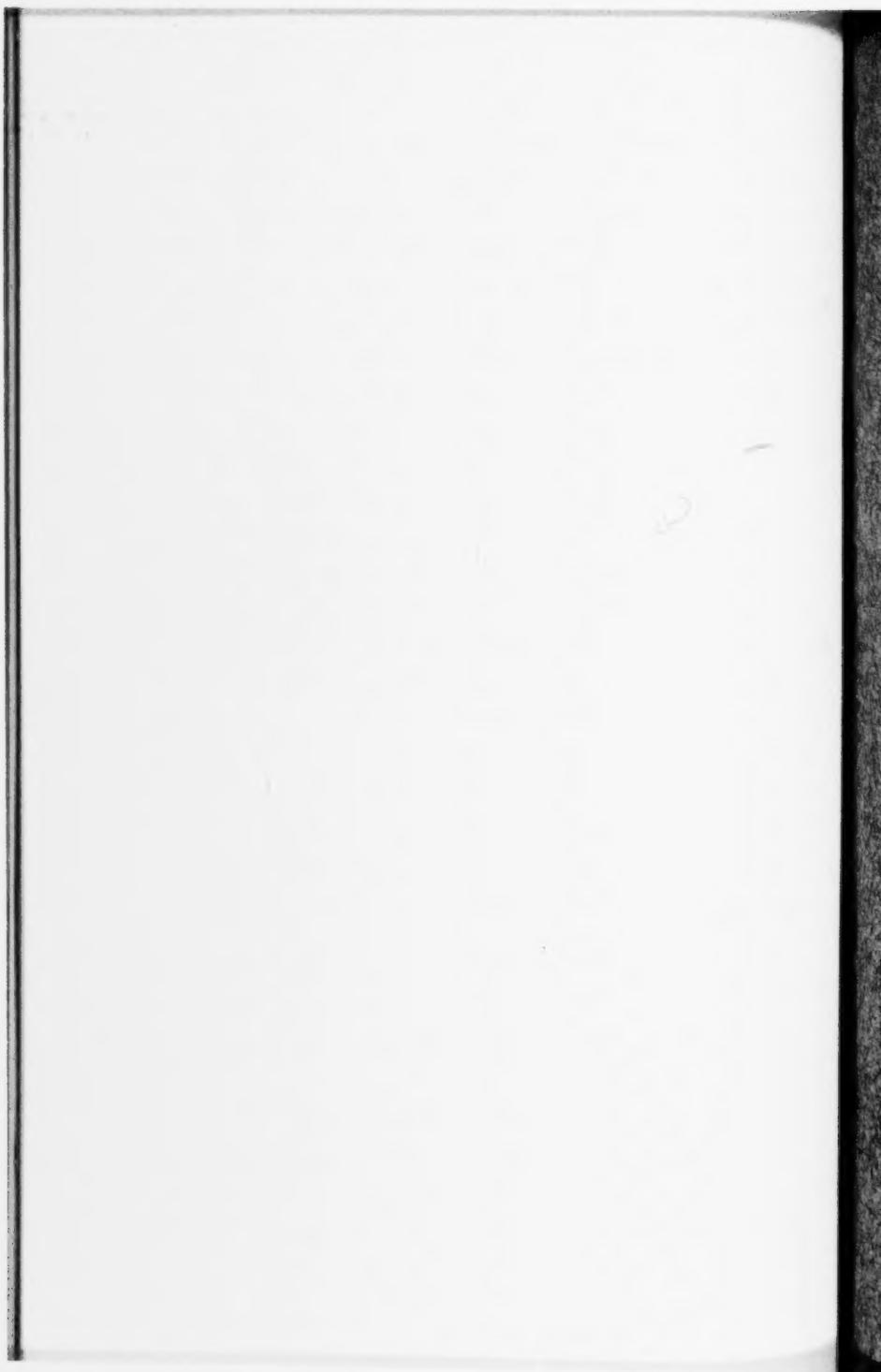
Wherefore, it is respectfully submitted that this petition should be granted.

Dated, San Francisco, California,
March 12, 1945.

GEORGE NAUS,

Attorney for Petitioner.

WILLARD L. ELLIS,
Of Counsel.



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1952

India's Economic Condition in the Second Year

EDWARD LINDNER

MANAS INSTITUTE OF ECONOMIC RESEARCH

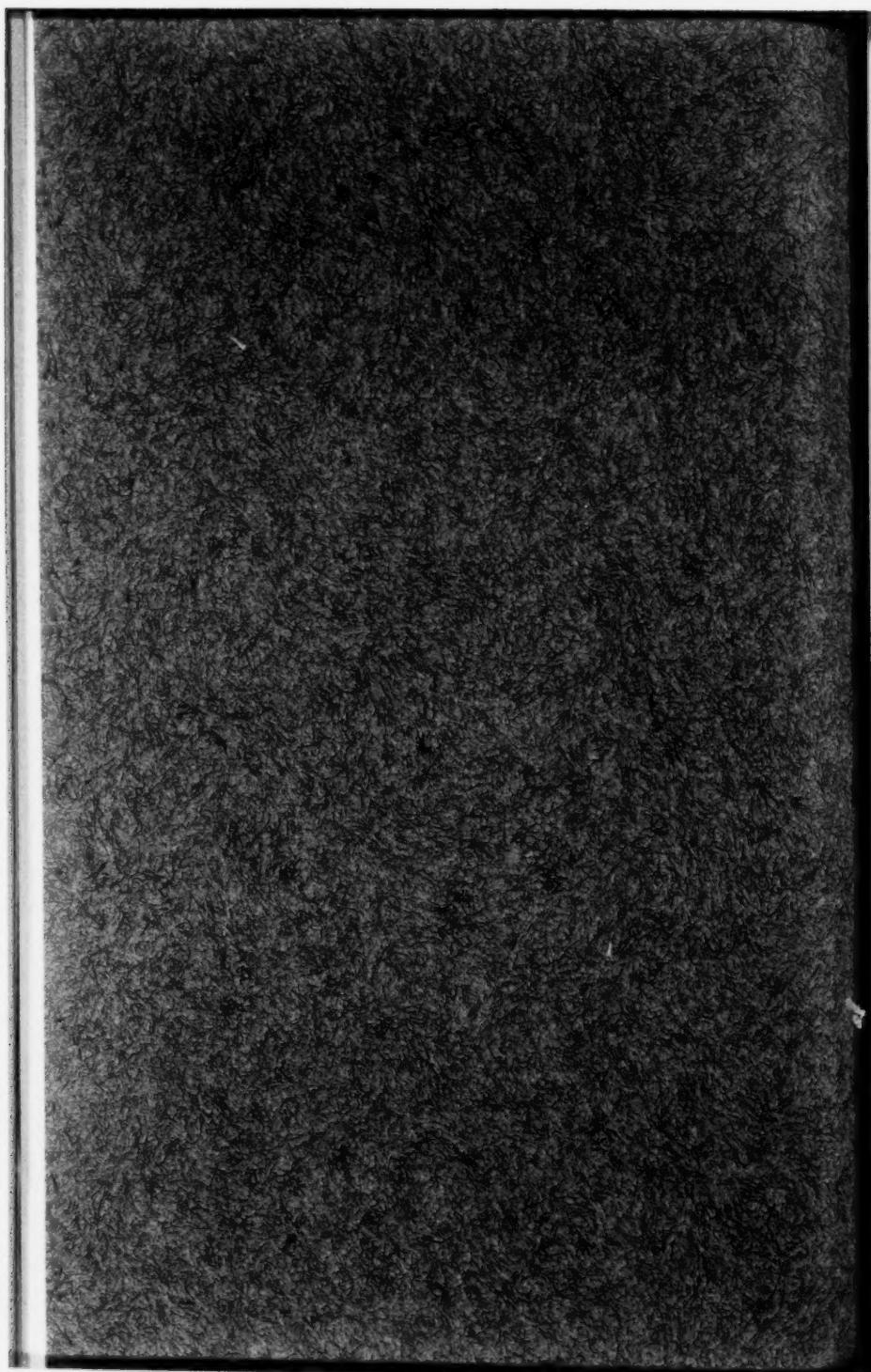
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In the Supreme Court of the United States

OCTOBER TERM, 1944

No. 1052

SANTA INEZ COMPANY, A CORPORATION, PETITIONER

v.

UNITED STATES OF AMERICA

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED
STATES CIRCUIT COURT OF APPEALS FOR THE NINTH
CIRCUIT*

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The District Court wrote no opinion and its findings of fact and conclusions of law (R. 25-34) are not reported. The opinion of the Circuit Court of Appeals (R. 225-230) is reported in 145 F. 2d 667.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on November 29, 1944 (R. 231). A petition for rehearing was filed on December 27, 1944, and was denied on January 2, 1945 (R. 232). The petition for a writ of certiorari was filed on March 19, 1945. The jurisdiction of this Court is

invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether, under Sections 22, 111, and 112 (b) (5) of the Revenue Act of 1934, a holder of certificates of deposit representing defaulted mortgage bonds of an insolvent corporation is taxable on the difference between the cost of the bonds and the larger value of his interest in the mortgaged property, when that property was sold to the bondholders' committee at public auction pursuant to a plan to transfer the property to a new corporation all of whose stock is distributed to the bondholders.

STATUTES AND REGULATIONS INVOLVED

These are set forth in the Appendix, *infra*, pp. 10-12.

STATEMENT

This is an action for the recovery of alleged overpayments of income, excess profits, and personal holding company taxes for the calendar year 1934. The facts found by the District Court (R. 25-34) may be summarized as follows:

On April 15, 1928, the Whitney Estate Company created an issue of \$1,200,000 first mortgage bonds secured by real estate upon which was situated an office building in San Francisco, California. On April 15, 1933, the company defaulted in the payment of interest and of that part of the

principal maturing on that date. These defaults were never cured. On June 1, 1933, a bondholders' protective committee was formed. Holders of the bonds deposited them with the committee and received certificates of deposit therefor. (R. 26.) In January of 1934, the committee formulated a plan pursuant to which the trustees under the mortgage would cause the property to be sold at public auction; the property would be purchased by the committee for the benefit of the depositing bondholders, and, thereafter, the property would be transferred to a new corporation in exchange for all of its stock which would be distributed to the depositing bondholders (R. 27). Pursuant to a request by the committee, the trustee caused the sale of the mortgaged property at public auction on February 28, 1934, and the property was purchased by the committee. It was paid for by the application to the purchase price of the distributive share of the net proceeds which inured to the approximately 95 percent of the outstanding bonds held by the committee, and by the payment to the trustee in cash of the distributive share of the net proceeds which inured to the benefit of the nondepositing bondholders. (R. 27-28.)

On the date of the trustee's sale, February 28, 1934, the taxpayer owned certificates of deposit representing \$136,000 principal amount of the bonds which it had purchased for \$59,421.25. The

taxpayer's pro rata share of the fair market value of the mortgaged property on the date of its purchase by the committee was \$104,328.95. (R. 28-29, 31.)

Due to the pendency of certain litigation, the committee did not obtain possession and clear title to the property until May 15, 1934. Thereafter, the committee proceeded with the plan to organize a new corporation and it (One Thirty-three Geary Corporation) was incorporated on September 4, 1934. The property was transferred to Geary on November 30, 1944, and all of its stock was issued to the committee for the benefit of the depositing bondholders. On December 10, 1934, the taxpayer received in exchange for its certificates of deposit 1,360 shares of this stock. (R. 28-29.)

In its original return for the calendar year 1934, the taxpayer reported no gain resulting from these transactions. In an amended return for that year, however, it reported as gross income the sum of \$44,907.70 as capital gain realized at the time of the purchase of the mortgaged property by the committee. (R. 30-31, 218.) The taxpayer paid the taxes and interest resulting from the inclusion of this gain as income for the year 1934 (R. 31-32), and after filing a claim for refund which was not acted on for more than six months (R. 33), brought this suit for their recovery (R. 33). The District Court wrote no opinion

but held that the taxpayer was entitled to judgment (R. 24-36). The Circuit Court of Appeals reversed (R. 225-231).

ARGUMENT

1. Petitioner's primary contention is "that no taxable gain resulted from" the sale at public auction "because bondholders acquire the status of equitable owners of the mortgaged property on the date of the default if the debtor is in fact insolvent" (Pet. 10). But Article 23 (k)-3 of Treasury Regulations 86 (Appendix, *infra*, pp. ~~16-47~~) provides, in part, that

if the creditor buys in the mortgaged or pledged property, loss or gain is realized measured by the difference between the amount of those obligations of the debtor which are applied to the purchase or bid price of the property (to the extent that such obligations constitute capital or represent an item the income from which has been returned by him) and the fair market value of the property.

This provision has appeared in the Treasury Regulations since the enactment of the Revenue Act of 1926,¹ and has been applied in numerous

¹ Article 153 of Treasury Regulations 69; Article 193 of Treasury Regulations 74 and 77; Article 23 (k)-3 of Treasury Regulations 86, 94, and 101; Section 19.23 (k)-3 of Treasury Regulations 103; Section 29.23 (k)-3 of Treasury Regulations 111.

cases. *Commissioner v. West Production Co.*, 121 F. 2d 9 (C. C. A. 5th), certiorari denied, 314 U. S. 682; *Commissioner v. Spreckels*, 120 F. 2d 517 (C. C. A. 9th); *Helvering v. New President Corp.*, 122 F. 2d 92 (C. C. A. 8th); *Hadley Falls Trust Co. v. United States*, 110 F. 2d 887 (C. C. A. 1st); *Malden Trust Co. v. Commissioner*, 110 F. 2d 751 (C. C. A. 1st); and *Brown v. United States*, 95 F. 2d 487 (C. C. A. 3d).

As a result of the acquisition of the mortgaged property by the bondholders' committee, therefore, the taxpayer then acquired an interest therein worth \$104,328.95. This interest was acquired for certificates of deposit representing bonds which had cost the taxpayer \$59,421.25. Under Sections 22 and 111 (Appendix, *infra*, pp. ~~10-11~~), and pursuant to the provisions of the Regulation above set out, a gain was realized by the taxpayer in that transaction, and since no provision of the statute directs that such a gain shall not be recognized, it was properly includible in gross income.

In neither *Helvering v. Limestone Co.*, 315 U. S. 179, nor *Helvering v. New Haven & S. L. R. Co.*, 121 F. 2d 985 (C. C. A. 2d), certiorari denied, 315 U. S. 803, rehearing denied, 315 U. S. 829, referred to by petitioner (Pet. 10), was it necessary to decide precisely when the bondholders' interest changed, for tax purposes, from that of a creditor to that of an owner. It was enough to decide that at some time prior to the exchange of

property of the old corporation for stock of the new, the bondholders had acquired a proprietary interest in the property.² There was thus no need to refer to the Treasury Regulation which, we submit, is controlling in this case.

To be sure, as *Helvering v. Cement Investors*, 316 U. S. 527, held, the subsequent transfer of the property to the new corporation in exchange for its stock was a transaction falling within the nonrecognition provisions of Section 112 (b) (5) (Appendix, *infra*, p. 42). But Section 112 (b) (5) deals only with the transfer of property to a corporation in ratable exchange for its stock. It has no effect upon, or relation to, the transaction pursuant to which the exchangers have themselves previously acquired the property. Those who transfer property to a corporation in a transaction falling within the scope of Section 112 (b) (5) may have acquired the property in any of various ways. The nonrecognition provided by Section 112 (b) (5) is of gain or loss resulting from the transfer of property to the corporation; the Section does not deal with the transaction, whatever its nature, whereby that

² These cases involved the "reorganization" provisions of the revenue laws and raised questions which, as the opinion of this Court in *Helvering v. Cement Investors*, 316 U. S. 527, 530-534, expressly noted, are not the same as that here presented. Not only is there no claim in the instant case that the "reorganization" provisions are applicable, but it has been expressly conceded that they do not apply (R. 50).

property was acquired by the transferors. And it is such a prior transaction which gives rise to the tax here involved.

2. Following the decisions of this Court, in 1942, in the *Limestone* and companion cases³ and the *Cement Investors* case, the field was canvassed by Congress and the entire subject, insofar as Congress deemed it necessary, has now been covered by statute. Section 121 of the Revenue Act of 1943, Public Law 235, 78th Cong., 2d Sess. It is true, as the petitioner states (Pet. 11), that these new statutory provisions apply only to cases where an insolvent corporation is reorganized pursuant to a court-approved plan. This, however, seems only to indicate that Congress did not believe that there was any practical necessity for legislative treatment beyond that point. We are informed by the Bureau of Internal Revenue, moreover, that the question here presented is involved in only eight cases pending in the various field offices, together with one pending in the Tax Court and one pending in a district court.

³ *Palm Springs Corp. v. Commissioner*, 315 U. S. 185; *Bondholders Committee v. Commissioner*, 315 U. S. 189; *Helevering v. Southwest Corp.*, 315 U. S. 194.

CONCLUSION

The decision below is correct. There is no conflict and the ruling of the court below seems to be one, not of general importance, but of comparatively narrow application. The petition should therefore be denied.

Respectfully submitted.

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Assistant Attorney General.

SEWALL KEY,
J. LOUIS MONARCH,
BERNARD CHERTCOFF,

Special Assistants to the Attorney General.

APRIL 1945.

APPENDIX

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—“Gross income” includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(c) *Determination of Gain or Loss.*—In the case of a sale or other disposition of property, the gain or loss shall be computed as provided in section 111.

* * * * *

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount Realized.*—The amount real-

ized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

* * * * *

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule*.—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as herein-after provided in this section.

(b) *Exchanges Solely in Kind*.—

* * * * *

(5) *Transfer to corporation controlled by transferor*.—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

* * * * *

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

ART. 23 (k)-3. *Uncollectible deficiency upon sale of mortgaged or pledged property*.—* * * In addition, if the creditor buys in the mortgaged or pledged property, loss or gain is realized measured by the difference between the amount of those obligations of the debtor which are applied to the purchase or bid price of the property (to the extent that such obliga-

tions constitute capital or represent an item the income from which has been returned by him) and the fair market value of the property. The fair market value of the property shall be presumed to be the amount for which it is bid in by the taxpayer in the absence of clear and convincing proof to the contrary. If the creditor subsequently sells the property so acquired, the basis for determining gain or loss is the fair market value of the property at the date of acquisition.

* * * * *

